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THE SOVIET ECONOMIC CRISIS

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

APRIL 25, 1990

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THE SOVIET ECONOMIC CRISIS

WEDNESDAY, APRIL 25, 1990

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:13 a.m., in room 2325, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton and Scheuer.

Also present: Richard F Kaufman, general counsel.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

There appears to be a strong consensus among Western and Soviet economists that the Soviet economy faces a crisis which could include something like a free fall or a deep recession. Less than a week ago the intelligence agency submitted its annual report to the Joint Economic Committee in which it concluded that the Soviet economy is in an unstable state with shortfalls in production, breakdowns in transportation and distribution, widespread shortages aggravated by hoarding, and a possibility of a further and perhaps precipitous decline.

A relative bright spot was reported in the agriculture sector which registered modest growth in 1989 following 2 years of decline. But most other sectors stagnated or fell last year. In addition, the Soviet international financial position worsened, and it ran a significant deficit in its hard currency trade.

The latest evidence indicates that economic performance is falling off further in 1990. Figures on national output by themselves do not seem that alarming. GNP, according to the intelligence agency, has increased by an estimated 1.5 percent in 1989, but the agency said that the usual types of statistics do not fully reflect the serious plight of the Soviet consumer because much of what is being produced is unwanted and remains in inventories.

Over the past week, a conference was sponsored by the American Enterprise Institute on the Soviet economy in which Soviet and Western economists, including representatives of the Central Intelligence Agency, discussed these issues, as well as the accuracy of the U.S. intelligence estimates.

In hopes of shedding additional light on the economic situation in the U.S.S.R., I have invited three well-known specialists on the Soviet economy, one from the Soviet Union, two from the West, to

testify on recent trends, current conditions and likely prospects. All three participated in the conference that I mentioned.

Vladimir Tikhonov is an economist specializing in agriculture who is also an elected member of the Congress of People's Deputies, and academician with the All Union Academy of Agricultural Sciences, and a professor at the Academy of Economy of the U.S.S.R. Council of Ministers. He has been at the forefront of those in the Soviet academic community who support economic reforms, and he advocates radical changes in agriculture, including decollectivization and widespread private ownership of farms. He is an enthusiastic supporter of the cooperative movement, and among his other capacities serves as Chairman of the Union of United Cooperatives.

Alec Nove is the distinguished professor of economics and for many years the head of the Institute for Soviet and East European Studies at the University of Glasgow in Scotland. He is the author of many books and standard reference works, including the Soviet economy and the Soviet economic system, both of which have gone into several editions. Mr. Nove is presently at the Russian Research Center, Harvard University.

Judy Shelton is a research fellow at the Hoover Institute, Stanford University and one of the new generation of Soviet specialists who has already made her mark. Her book, "The Coming Soviet Crash," published in 1989, was an original and provocative examination of Soviet financial imbalances and of Moscow's intentions in seeking Western credits.

In this proceeding, each witness will have about 10 minutes to summarize his or her views. The prepared statements that have been submitted will be printed in full in the record. The witnesses are also invited to submit to the committee any other written materials they feel are pertinent.

Mr. Tikhonov will speak in Russian accompanied by simultaneous translation. After each of the witnesses have spoken, the committee will pose questions to them.

Mr. Tikhonov, you may proceed first. You are the first Soviet economist to testify in this committee's hearings on the Soviet economy. We are especially pleased to have you with us here, and you may begin, sir.

STATEMENT OF VLADIMIR TIKHONOV, MEMBER, CONGRESS OF PEOPLE'S DEPUTIES, U.S.S.R.

Mr. TIKHONOV. Ladies and gentlemen, I am very grateful to you for this invitation, and this is my great honor to be present at this hearing.

It is true that the state of the economy of my country is extremely bad. And as of today, I do not see any symptoms that would indicate any changes in the near future.

The most vulnerable today is the state of the consumer market. Delivery of goods to the consumer market is decreasing every day.

Alongside with this, irrespective of the attempts of the Government to restrict the monetary income of the population, monetary incomes are growing even in higher rates than it had been before. Last year the Government had to adopt a decree about the freezing

of wages and salaries. However, during the first quarter of this year the mass monetary income of the population has increased by 15 percent. If we can believe our official government statistics, then the mass of consumer goods has increased by 5 percent. Even this testifies to the fact that our economy is extremely ill.

But I want to say that the growth of consumer goods is related to the hike in prices. Actually, according to my calculations during the first quarter of this year, the production and supply of consumer goods in the physical sense has declined by 3 or 4 percent. In this sense, inflation is growing with very high rates and the ruble becomes less and less valuable.

A number of economists in our country hope that the inflation can be averted if the prices are going to be higher and higher, more precisely the complete reform of all the Government prices, alongside with the general statewide monetary reform. I don't think such measures will yield positive effects.

It is the unsatisfactory structure of the Soviet national economy that is the very serious reason of the bad situation of today. Unfortunately, little is being said about it both in the Soviet and Western press. Namely, the unsatisfactory structure is the very deep reason for the very serious crisis that we are experiencing today. The point is that our national economy was always formulated as an economy which has very powerful industrial and military strength. That is why the majority of the productive forces is concentrated in the industrial industry, including the military industry. And naturally during all of the 70 years, the production of consumer goods was always chronically behind.

So, the situation today is that if we do not deliver goods to the consumer market, the country is not going to get out of the existing crisis. This requires the relative reduction in the capital goods production and a very rapid increase of the production of consumer goods. Such a radical and key restructuring of the economics is very expensive, and today our government cannot afford doing something like this.

In the recent time, the trade system has been developing rapidly. So, alongside with the increase of certain types of products, constant losses are taking place. Waste and losses, of course, most of all concern agricultural products and food products. The most optimistically oriented Soviet organizations, such as State Planning Committee and State Statistical Committee, have to realize that as a minimum of 30 percent of the produced agricultural products are wasted, but actually in reality such wastes and losses are even greater. They occur at the so-called after agricultural stage, I mean, in the system of trade and processing industry. Actually as compared to the figures given by our statistics, the scope of agricultural products that are being processed and delivered to the end users is no more than 50–54 percent. Naturally when we have such wastes and losses, we will not be able to resolve the food problem and to strengthen the food oriented market.

So, what way out can we see from this very difficult crisis situation?

No. 1, radical changes of the entire economic system, rejection of the state monopolism in economy and privatization of our economy. We deem it necessary to denationalize our industry as soon as pos-

sible, which means that the state-owned enterprises will be turned into various types of nongovernment formats and facilities, including the individual; that is, private ownership of those facilities.

No. 2, deconcentration of production is necessary. It is the development of a system of small and medium size businesses that perhaps would serve as the major aim of deconcentration of economy, those facilities and enterprises that are oriented directly to the market and the end user.

No. 3, and I think this can happen, that is, the shutdown of several state-owned enterprises and facilities that produce products that nobody uses. Let me give you a short illustration that you would understand what I mean.

For example, there is a factory that produces ball bearings. About 4,000 people work at that factory. That factory works according to the plans that had been given to the factory by the state and produces the ball bearings that at the present time cannot be used by anybody. However, the Government pays for these ball bearings. Then all the products are directed and supplied to the steel factory, remelted to the steel that, of course, the Government also pays for, and then the very same steel comes back to the very same factory to produce the very same ball bearings.

I think that somebody can laugh and say this was not realistic, but unfortunately this is one of the most widespread forms of the system of our national economy.

Of course, if we close such facilities, we will have unemployment. It seems to us that the scope of unemployment can be as high 10–12 million people. I think that this is one of the most important reasons that restrict our government because they are afraid of very unfavorable reaction and turmoil on the side of the population. This way or other, our country will have to overcome all these difficulties and have all those tests. So, I think that the transition to the free enterprise system is the only way that we can use to save our economy.

We all are very sorry that our government, including our President Gorbachev, have made the decision to postpone the writing of the reform. It has been done evidently for fear of large statewide cataclysms because when such reform would go on this way, the prices would go higher and higher. But I would like to repeat something that I always say in the U.S.S.R. The more we postpone the beginning of intensive reforms, the less possibilities and opportunities our government would have to create social compensation funds to those segments of the population that undoubtedly will suffer during the transition from the regulated system, controlled system, to the market system. That is why we now are trying to do our best to convince our government not to drag on with the reform and to begin decisive measures for the transition to the free market and free enterprise system.

In conclusion, very briefly about the immediate forecast and immediate prospective as far as I am concerned. If the Government does not start reforms actually today, tomorrow or the day after tomorrow, then we will have a breakdown, and this crash will cause antigovernment social movements. And I think that we can have a situation that the Government will use repression measures to a certain extent. If we start our reform directed to the denationaliza-

tion and privatization of the consumer goods and the market, then we will have a year or a year and a half of the decreased standards of living of our people, but today the Government still has the opportunities to apply the known, state-owned compensations which will provide for the weakening of unrest and unsatisfactory situation among the people so that in about a year or a year and a half, we would, to a certain extent, be able to normalize the market of food and agricultural products.

Of course, it is easy to give advices to the Government, but it is not that easy to fulfill and follow those advices.

There was a book and I read it once that a wise man was asked how to catch a tiger. So, the answer of that man was you should catch two tigers and then let the other one go free. I don't think that our government would be able to catch two tigers, but one tiger that is the transition to the free enterprise system is quite real.

Thank you.

Representative HAMILTON. Thank you, Mr. Tikhonov.

Mr. Nove, please proceed.

STATEMENT OF ALEC NOVE, RUSSIAN SCHOLAR, RUSSIAN RESEARCH CENTER, HARVARD UNIVERSITY

Mr. NOVE. I circulated my prepared statement which I wrote 2 weeks ago. There I stressed that I agree both with Mr. Tikhonov and, indeed, with Judy Shelton that the situation is very serious. In my prepared statement I quoted a number of published government statements to this effect. And these statements emanate from people of very divergent views, and it is an important fact of contemporary Soviet life that pluralism is reality and there are many different views expressed.

The conservative nationalist Prokhanov wrote: "The dismantling of the command-administrative system has in practice led to the destruction of our economy, making it totally unmanageable, causing chaos and disintegration of whole sectors."

The very influential academician Shatalin, in my opinion an admirable economist of a quite different political viewpoint has stated publicly: "It is not a matter today of saving socialism, communism, or any other ism. Today we must literally speak of how to save our people, our nation."

Others have written: "The economy and society are in condition of deep crisis," and so on and so on.

I had put in my prepared statement, three such quotations. I could have easily have put 33 such quotations.

How they got into this mess, why is it that under Gorbachev, a reformer, after 5 years of perestroika, the economic situation seems to have disintegrated is something that I do try briefly to discuss in my prepared statement.

No one doubts the urgent need for change, but there was no thought-out strategy of transition. Indeed, there is no theory of transition from a highly centralized economy to what? To market socialism? There is widespread disagreement among Soviet economists as to what they should precisely transition to. It is not only a question of resistance from bureaucrats, there is the uncertainty as

to precisely what alternative to the existing system should be adopted and among the difficulties is also the lack of understanding by many, many ordinary people of what a market economy is supposed to be like.

This lack of understanding affects management that has never had to market anything because it has always been told whom to supply what products to, but also ordinary people have been told for 70 years that buying and selling is speculation, that although it seems to us perfectly natural, that if there are no apples in Krasnodar and there are apples in, let us say, Rostov, it is perfectly proper for somebody to go and buy apples where there are apples, take them to where there are no apples and sell them at a profit. Now, not only is this illegal for private individuals to this day in the Soviet system, but a surprising number of millions of Soviet citizens think it should be illegal. The question of public opinion, the acceptability by the public of the kind of radical market reform, proposed by the radical reformers, such as Mr. Tikhonov, is one of the obstacles that undoubtedly make their implementation difficult.

The other point which I think is right to stress and I briefly stressed in my prepared statement is the sense of—how can one put it—a loss of confidence and sense of direction in the whole of society, affecting the leadership too. This affects political power. It affects legitimacy of political power when a member of the Politburo can write as recently he did, "Russian Marxists failed to notice some evident contradictions in Marxism."

If the Soviet press, now very widely free, can speak openly as it has done of the crimes of Stalinism, of the inadequacies of the system, if as is now repeatedly stated and was stated by two of our Soviet participants at the Airlie House conference, that the relative position of the Soviet Union vis-a-vis the United States is actually slightly worse than it was in 1913, does this not lead to a general sense that the whole of Soviet history since 1917 has been a long journey on the wrong road? And people half jokingly say socialism has proved to be the longest road from feudalism to capitalism.

Well, now, I am not saying that all this is right or wrong. I'm saying that when this feeling is widespread and the regime, to a considerable extent, loses its own sense of legitimacy, then the very complicated, very troublesome and burdensome measures that are necessary to bring health to the sick economy are extraordinarily difficult to take. You have to decide to take them. You need the political will to implement them against opposition of many people who do not understand that this is what requires to be done, and one has the impression that the disarray of the economic system where the old methods no longer really work—the new ones, the market is not in place—is associated also with the disarray of the political system so that after my recent stay in Moscow, I came to the conclusion shared by many that even if the Government were to decide to do the right thing, whatever that is, it will probably be unable to implement the decisions.

Clearly, one important reason for disarray of the economy has been the very serious errors in monetary and fiscal policy, the devaluation in practice of the ruble which has gone psychologically to

such an extent as to gravely affect people's willingness to work. Why work if you are paid in rubles, which as one of my Soviet colleagues put it, "the ruble is no longer a currency; it is a lottery ticket"? What are you likely to get for it? Anybody who tries to get a taxi in Moscow will know an offer of foreign currency or red Marlboro cigarettes—I don't know why they should be red—can produce a taxi, where rubles in almost any amount may be unable to do so.

How is it that they have come to this remarkable state, how is it that the Soviet authorities in carrying out or seeking to carry out desirable reforms in the direction of creating a market allowed the money situation to degenerate to such an extent that the market cannot operate is a very interesting question. I put it repeatedly in Moscow and was never quite happy with any of the answers.

Well, what then can be done? To cite my prepared statement which I circulated and which was written 2 weeks ago, "We are told that a high-powered committee of top advisers is about to present Gorbachev the package of radical measures which will show a way out of the crisis." If I were writing it today, I would have to say that the evidence, official and unofficial, in the Western press and from what we heard at Airlie House suggests that they have shied away from the necessarily painful measures on the grounds in their judgment that the political consequences would be shattering. And who are we necessarily to question that judgment?

Very typical, a quote from the party's own journal Kommunist, is the following view. "Everyone knows that the prices we have are absolutely useless. It is particularly clear that the existing price system has a paralyzing effect on carrying through the economic reform. But . . . ." And of course, he goes on and he says sadly, yes, we know what the Poles are trying to do, but in the Polish model there is a government of national salvation in which most Poles have faith. The present regime no longer carries that with it, that kind of faith, and so, the shock therapy on the Polish model, would it work? "Is our country ready for such a program of stabilization and radical market reform? Will our population be able to bear the hardships which inevitably accompany it?" I agree with Mr. Tikhonov that, if it is put off, the slide downward will continue and the extraction from the abyss, the precipice, correspondingly more difficult.

And in the last minute or two, if I may, just one or two words arising from the impressions at the Airlie House conference.

One, that while the CIA's estimate both of past growth and the present state of the Soviet economy are, of course, more negative than the official statements in Soviet statistics now largely discredited, almost all the Soviet participants made estimates which are lower than those of the CIA both in respect of the present state of the economy and its relative strength vis-a-vis the United States. And it is an interesting question, to which a large part of the Airlie conference was in fact devoted, to inquire why this is so.

One or two puzzled Soviet participants over coffee were sort of asking how is it that the CIA comes up with figures that are too high. It is a puzzling thing to be witnessing.

The other thing that emerged in the Airlie House conference is that those Soviet participants that made estimates of the military

burden tended to make that not only a good deal higher than the higher figures now published by the Soviet themselves, but in some cases higher also than the CIA's estimates.

And finally, reading the CIA's submission, which, of course, I hadn't read when I wrote my own, "The most likely outcome for 1990 is that the Soviet economy will stagnate or decline slightly." I do not in the least enjoy forecasting catastrophe, but it seems to me that, if you measure degrees of likelihood, it will be slightly worse than that, though perhaps not much.

Thank you.

[The prepared statement of Mr. Nove follows:]

PREPARED STATEMENT OF ALEC NOVE

The Soviet economy has entered a period of acute crisis, and the theme of approaching disaster is to be found in many public statements, by persons of widely divergent views. Here, for example, is the conservative nationalist A. Prokhanov: "The dismantling of the command-administrative system has in practice led to the destruction of the economy, making it totally unmanageable, causing chaos and the disintegration of whole sectors." Or take the remarkable speech to the February 1990 Plenum of the Party's Central Committee by Academician S. Shatalin, a radical reformer: "It is not a matter today of saving socialism, communism, or any other -ism. Today we must literally speak of how to save our people, our nation." One more quotation, from K. Kagalovsky in the Party's theoretical journal *Kommunist* (No.4, 1990): "The economy and society are in condition of deep crisis." As many sources attest, the previously-existing economic *and* political command structures are in process of falling apart, but new ones are not, or not yet, in place. For reasons to be examined in a moment, the market has not replaced the increasingly ineffective centralized planning mechanism. In the words of E. Gaidar (*Kommunist*, No.2, 1990), "Here is a situation of a unique kind of economic powerlessness."

An important element in the crisis is the loss of confidence and sense of direction, affecting both leaders and led. A commonly encountered headline is "Where are we going?" The old dogmas are under attack even from members of the Politburo (e.g., "Russian Marxists failed to notice some evident contradictions in Marxism," said Yakovlev), while both Abalkin (vice-premier in charge of the reform process) and Shatalin assert the need for a total rethinking and redefinition of "socialism." The increasingly free media print also the views of those who have no time for "socialism" in any definition, and who believe that the whole of Soviet history since 1917 was a tragic error, that history will show that "socialism is the longest road from feudalism to capitalism." *Glasnost'* is real, every sort of voice is being heard, including those of nationalists who wish to secede from the USSR, and of Russian nationalists too. The

the system of social compensation to those people, who due to certain circumstances cannot get adjusted to the free market system.

There are 48 million Soviet people like this. The more we postpone the transition to the market economy, the more amount of people like this we will have. And one of the reasons why I think that Gorbachev's decision was wrong is the fact that by the end of this year the number of people who live beyond the limit of poverty and who need compensation will increase to no fewer than 55 million. That is why the transition to free market with the compensation system must happen immediately.

Of course, the Government can still regulate the market by the system of limitation of restricting levels for prices. Well, I would like to emphasize not fixed prices but only price levels. So, if you go beyond those levels, those limits, you will be penalized and/or your taxes would grow immensely. Well, I mean, the taxation system, government investment system, et cetera.

This is my concept in the general sense.

PROSPECTS FOR WESTERN BUSINESS

Representative HAMILTON. Mr. Nove and Ms. Shelton, are things so bad in the Soviet Union today that you would advise the Western business community to stay out or to get out?

Mr. NOVE. A good deal depends on the nature of the activity.

Representative HAMILTON. McDonald's is OK?

Mr. NOVE. Yes. This is not a time when one takes big risks. But, for example, just a point that occurs to me at random, a number of Western firms have been participating in the building of hotels. Hotels earn foreign currency. Therefore, the remittance of profits is a relatively easy matter. The need for hotels is self-evident. Tourism is underdeveloped. It is a huge possibility there.

Of course, if there is riot and civil commotion and someone sets fire to the hotel, that would be a pity, but I think the potential is such that the risk is worth taking. But there are certain other kinds of industrial investments, highly desirable from the Soviets' point of view, which may at present genuinely appear too risky.

Representative HAMILTON. Ms. Shelton, how do you feel about that?

Ms. SHELTON. Well, I think you have to distinguish, as Mr. Nove did, between operations where you can get paid in hard currency and operations where you get paid in rubles, and in the travel business, hotels, you are getting paid by foreigners who are traveling in the Soviet Union. So, I think you are all right. At least you can make a profit for the near term.

The Soviets, though, are now some $500 million in arrears on hard currency payments to suppliers in the West, and this is now being revealed. Du Pont and some other people who are owed money by the Soviets are complaining out loud.

Soviet creditworthiness has declined precipitously in the last couple of months. They came out with a Eurobond in January, 500 million marks, about $300 million. It first offered a rate of return of 8.87 percent, and 30 days later in late February, it had been repriced by the market so that the Soviets were now forced to pay 10 percent on that Eurobond. And I think that is indicative of this de-

latter assert that the other nationalities exploited the Russian people, and some find it convenient to blame the Jews for just about everything. Politics as such is not today's subject, but clearly it requires political will *and* political power to find a way out of the crisis, and the number of discordant voices complicates the task. Another common saying: "One cannot overleap a precipice in two installments, and especially if it is not clear in which direction to jump."

Why have things gone so wrong? What remedies are there which might save this situation?

The rot, the stagnation, the corruption inherited from Brezhnev did call for genuinely radical reform. Gorbachev and his closest advisers saw that bureaucratic centralism was responsible for intolerable inefficiency and waste, and that a shift toward a *market* mechanism represented the only solution. But:

1. There was no thought-out strategy of transition. Many of the measures taken were half-hearted compromises, contradictory, confusing.

2. The needed trained personnel and market institutions and information flows are still to be created. Everyone had become accustomed to working within the old system, where a multitude of informal links and bargains supplemented (sometimes supplanted) the formal chain of command. Reform would have encountered major obstacles even if no one opposed it and everyone agreed about what to do.

3. But there *was* opposition, not only from "bureaucrats", but also from ordinary people, who feared job insecurity and had been taught for fifty years to regard private entrepreneurs as "exploiters" and "speculators", to be suspicious of market forces.

4. In 1988 and 1989 the budget deficit grew dramatically. The reasons: the fall in the oil price, the fall in revenue from vodka because of the anti-alcohol campaign, the cost of the Chernobyl disaster and of the Armenian earthquake, extra expenditures on the grossly underfunded medical services and housing, plus the rapid growth of food

subsidies. At the same time the loosening of control over enterprise finance resulted in a wage explosion, while efforts to cut back on the grossly excessive number of investment projects were unsuccessful. There was an upsurge of inflationary money creation, while attempts continued to hold down prices. This led to growing shortages, both of consumer goods and of industrial inputs, and this in turn led to hoarding and excessive inventories, which made shortages worse. "The ruble is no longer a currency, it is a lottery ticket," to cite a Soviet colleague. In such circumstances, a transition to a market economy could hardly be expected to occur. Rather than sell for rubles, management sought to make barter deals. There is a huge monetary "overhang."

By the middle of 1989 the leadership realized that they were heading for disaster, and a number of remedial measures were taken, including cuts in the defense budget, a sharp increase in vodka sales, the freezing of some big investment projects. But the view of the best Soviet economists was: too little, too late. Deterioration continued, exacerbated by trouble in many of the republics and the decline in the authority of the center: republics and regions have started defying orders and refuse to deliver goods to outside customers. Coal miners and now also oil workers demand the right to sell directly to foreigners for hard currency and to spend the money of scarce consumer goods for themselves. Most fundamentally, prices remain basically unreformed. Kagalovsky wrote, "Everyone knows that the prices we have are absolutely useless. It is especially clear that the existing price system has a paralyzing effect on carrying through the economic reform. But...."

But for years now the leadership has been paralyzed by fear of the consequences: maybe big riots in the streets. As for the urgent need to balance the budget, it is unnecessary to say to members of the U.S. Congress that this presents a few problems not only in Russia. Various plans have been mooted to "tie down" or reduce the excess money in the economy: bonds at high rates of interest, life insurance, pension supplements, payment in advance for future delivery of cars and apartments, the

freezing or "devaluation" (directly, or through inflation) of savings bank deposits, the issue of a limited number of "gold" convertible rubles, foreign-currency auctions, and so on. All these ideas have point. But up till now there has been no attempt to implement a radical and interconnected *package* of reform. Laws have been adopted on the rights of enterprise management, on leasing farms to families, on producer-cooperatives. However, the government has failed to grapple with monetary disorders, or to tackle the basic issue of prices, and the recently-adopted law on property falls short of legalizing private employment.

We are told that a high-powered committee of top advisers is about to present to Gorbachev the package of radical measures which will show a way out of the crisis. Perhaps we will know the contents of the package by the end of April. If it is serious, it *must* include a price reform that is real, i.e. a very large rise in prices of necessities, drastically reducing subsidies, with some compensation for pensioners and others with low incomes. This is strongly hinted by Abalkin in his article, published in *Pravda* on March 30. There may well be "shock therapy" on the Polish model, though Kagalovsky is uncertain "whether our country is ready for such a program of stabilization and radical market reform. Will our population be able to bear the hardships which inevitably accompany it?" And will Gorbachev, who has so often accepted unworkable compromises, be willing this time to act decisively? There are serious risks involved, a firm hand is essential, the independent-minded Supreme Soviet may make difficulties, the nationalities crisis will further complicate matters. Strikes could break out in key industries, and on the railways, with disastrous cumulative effects on supplies and on production. Indeed, output is already falling. The next few weeks will be decisive. No one denies the possibility (pessimists say -- the likelihood) of failure, even of collapse.

I do not think that the West could do much to help, even if we all agreed that we should help. The sheer scale of the task of recovery and reform means that success will depend overwhelmingly on internal factors. They would not dispute this: it is for them

to get their own house in order. They desire to expand trade relations, and this we should encourage, but with oil production falling, they will have serious problems in maintaining, let alone increasing, their hard-currency exports, while recent events are bound to disrupt their trade relations with Eastern Europe. They are reluctant to incur large-scale additional debts, though in fact their indebtedness is growing. We can help marginally, by granting most-favored-nation treatment, by pruning the excessively long Cocom list, by facilitating and not obstructing various joint ventures. I disagree strongly with "Z". Gorbachev's Russia is one we can live with, it has evolved with surprising rapidity towards democratic elections, cultural diversity, genuine glasnost." Even two years ago who would have imagined that the "Gulag Archipelago" would appear in a mass-circulation magazine? It would be sad if all this were to be destroyed along with the economy. Any envisageable alternative to Gorbachev would be much more unpleasant. And surely the Russian people have suffered enough in the twentieth century ...

Representative HAMILTON. Thank you very much, Mr. Nove.
Ms. Shelton, please proceed.

STATEMENT OF JUDY SHELTON, RESEARCH FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY

Ms. SHELTON. Mr. Chairman, thank you for asking me to offer my views here today on the economic crisis in the Soviet Union.

As Chairman Hamilton mentioned, I wrote a book titled "The Coming Soviet Crash." It was published over a year ago. Since then I have been asked on many occasions: What exactly do you mean by a crash or collapse for the Soviet Union and just when is this crash going to take place?

STEPS LEADING TO A CRASH

There are different levels that can be discussed when speaking of a crash. I would like to attempt to define them here and then use this approach to describe the position the Soviet Union finds itself in today:

One, monetary dysfunction refers to a situation where there is a severe imbalance between the amount of money in the system and the amount of goods available for purchase. This kind of imbalance distorts the incentive effects that would normally encourage greater work effort and higher production. Even where central planning is involved, money serves as an organizational tool for distributing resources throughout the system. So, if the money is out of kilter, the allocation of economic resources is likewise disrupted.

Two, the next level up, in terms of discerning the magnitude of a crash, is a more general financial and economic breakdown. A runaway money supply reflects fundamental budgetary imbalances; namely, inadequate revenues to the budget relative to the level of expenditures. Chronic deficit financing leads to the creation of excess credit within the system, and this excess credit tends to exacerbate the problem of deteriorating revenues because it enables unprofitable enterprises to continue to function.

Three, as a result of economic breakdown, a drop in the amount of consumer goods available, and a perceived decline in the standard of living, the next level of a crash is expressed in terms of social turmoil. Widespread corruption and increasing crime rates are evidence of antisocial behavior. Organized demonstrations and massive labor strikes indicate extreme dissatisfaction with the existing situation and resentment toward the current government for the mismanagement of economic resources.

Four, the final step occurs when social frustration over poor economic conditions turns to outrage. At this point, political upheaval can take place. Under the right circumstances this can be a useful exercise, a cleansing process that removes the old governing apparatus and replaces it with a competent one that is acceptable to the people. Unfortunately, however, political upheaval is often accompanied by violence. Instead of bringing about improved levels of social welfare, it can perpetuate conditions for political instability, economic chaos, and social anarchy.

WHERE THE SOVIET UNION IS TODAY

Where does the Soviet Union fit on this hierarchical scale of dysfunction leading to full-scale collapse? In my opinion, it is poised on the cusp between step 3 and 4. That is, there currently exists an extremely high level of dissatisfaction among the Soviet people over their situation, and this is being expressed through labor strikes, civil unrest, challenges to central authority and mass public demonstrations. I believe the Soviet Union is very close to that point where social outrage turns into political upheaval and anarchy.

As Boris Yeltsin put it when he visited here last year, his country is standing at the edge of the abyss. Using Yeltsin's analogy, I would say that it is about to fall in.

Is there some crucial factor, some defining event that will deal the final blow? I put that question directly to a prominent Soviet economist 4 days ago. As Chairman Hamilton mentioned, a conference was held in Warrenton this past weekend where a group of highly respected Soviet economists met with CIA analysts and U.S. military, economic and financial specialists to discuss statistical discrepancies on both sides.

The answer this particular Soviet economist gave was that his country could be characterized as a powder keg and that Lithuania was the matchbook. Whether it blew up depended on how Gorbachev handled the situation. I commented that Gorbachev was an intelligent man. The Soviet economist held up a finger and made a distinction. "He is a cunning man."

Even in the absence of a dramatic showdown in Lithuania, I think economics will prove more volatile than politics, though the two are clearly related. My own feeling is that domestic price reform will turn out to be the match that ignites social explosion in the Soviet Union. Gorbachev's latest radical economic reform package was supposed to have been formulated and announced earlier this month. Rumor had it that the plan would contain measures to implement price reform, make the ruble convertible, allow private property, and denationalize many state-owned enterprises. There are indications now, however, that this effort has become bogged down in committee and that its potential economic impact has already been fatally compromised. And as of yesterday, we have learned that the program has been officially delayed.

The Soviet leadership is justifiably concerned that if prices are allowed to rise as high as Soviet economists insist they must, which means roughly doubling the prices on most consumer goods, the psychological and ideological blow to Soviet citizens will prove devastating. Perhaps one-third of the population could be pushed below the poverty line if fixed-price ceilings were eliminated. High inflation would be fanned by the monetary overhang of accumulated savings, even as rising unemployment and productivity losses acted to further reduce the overall supply of consumer goods.

Worried officials are becoming increasingly preoccupied with the need to introduce compensatory measures and social safety-net features to calm public fears. Gavriil Popov, a radical free-market economist who became mayor of Moscow last week, believes that the nation's capital must immediately establish 30 to 50 free food

canteens and dozens of shops with free clothing to compensate citizens for the expected drop in living standards. There is a strong national movement, too, to double the monthly pensions of tens of millions of Soviet retirees and disabled workers. In addition, Soviet farmers are demanding substantially higher prices from Moscow or else they will refuse to make grain deliveries.

IRRECONCILABLE CONFLICTS

These demands, all viewed as social necessities, are budget busters at the same time. The whole idea of removing price ceilings is to relieve the Government from the budgetary burden of having to pay subsidies to keep the prices of basic consumer goods artificially low. For the Government to be forced to incur higher subsidies for transfer payments and welfare benefits and to make additional payments to agricultural cooperatives is to defeat the objective. The Soviet budget deficit, already nearly four times greater than the U.S. budget deficit as a percentage of gross national product, could end up even larger. This would require additional internal financing, releasing untold billions of excess rubles into the system and bringing on hyperinflation.

All of which illustrates the profound difficulty of attempting to reconcile socialist doctrine with free market mechanisms. When the Soviets talk about their willingness to introduce a regulated market, they belie the wisdom of Czechoslovakia's Finance Minister, Vaclav Klaus, who insists that what is needed is a market economy without any adjectives. The Soviets are concerned about clipping the wings of a bird that has yet to learn how to fly.

After dinner last Saturday, one of the Soviet economists at the Warrenton conference explained the dilemma this way: "The Government is attempting to treat society as if it had a runny nose, when in fact it has leukemia." This economist believed that Soviet society was being destroyed by the dual evils of political dictatorship and economic monopolism as exercised through the state apparatus. He felt that free enterprise and market reform could not be successfully introduced until dictatorship and monopolism were dismantled.

All of the Soviet economists present at the meetings, including several who are directly involved in formulating economic policy in Moscow, agreed that excess money in the Soviet system was a primary obstacle to reform. Yet there was no consensus on how to go about resolving the problem. Earlier this month, when Soviet Deputy Prime Minister Leonid Abalkin referred to the new economic plans under consideration, he said that the package would contain no initiatives for monetary reform.

In my opinion, this is the single most important cause for pessimism. As stated at the outset, monetary dysfunction is the first widely visible manifestation of the kind of deeper economic problems that lead to social and political instability. The connection between a nation's money and a nation's destiny is a logical one. The creation of money is one of the most treasured sovereign rights of any government. Indeed, the soundness of money is seen as a reflection of the soundness and viability of the nation that created it. In that respect, the Soviet Union is in deep trouble.

Thank you.

Representative HAMILTON. Well, thank you very much to each one of you for excellent statements.

GORBACHEV DELAYS REFORMS

Let's begin with this question of Gorbachev's apparent decision to delay the so-called shock therapy. The question is, Did he make the right decision under the circumstances?

Mr. TIKHONOV. Let me try to begin answering this question first. Of course, I am not saying that my statements would be all true.

I am convinced that the decision has been incorrect. This decision would drag on the agony of our national economic system. I think that during the transition stage to the free enterprise in our country, it is not necessary to use one single method that based on the Polish experience was called shock therapy.

The complexity lies in the fact that today's crisis situation of the Soviet national economy did not happen overnight. It was not a situation that happened as a chance. It was the longstanding wrong political action. It is the objective result of the economic policy that had been in effect during 70 years. This is a result of the system of government monopolism in economy that was thoroughly and indicatively formulated beginning in 1922. It could not lead to anything else but the crash of the market. And to those, these proportions that at the present time are the reasons for that crash.

Representative HAMILTON. Mr. Tikhonov, how close is your country to the conditions that Ms. Shelton spells out so that you would have an upheaval of some kind? We will come back to the other witnesses with respect to my earlier question.

Mr. TIKHONOV. I don't think that we should reject Ms. Shelton's opinion like this.

Representative HAMILTON. Is it a likelihood?

Mr. TIKHONOV. That's why I said that we should not reject it. Position No. 4 of her presentation is quite real, and it is more real the more we drag on with the beginning of the actual transition of our economy to the market system.

Representative HAMILTON. Mr. Nove, how do you feel about Mr. Gorbachev's decision? Was it justified?

Mr. NOVE. It is always difficult, of course, to criticize a politician who firmly believes that if an unpopular, but necessary decision is taken, he may be hanged from the nearest tree.

I think I agree with Mr. Tikhonov. It is a mistake, and as time goes on, the necessary measures will become even more painful and there will be still more reasons for doing nothing.

As far as the not so much disagreeing, but a brief comment, if I may, on what Mr. Tikhonov said about the underlying deep causes. The underlying deep causes explain why the old system had to go and why Mr. Gorbachev came in with a program of perestroika. The sad and almost tragic fact is that a number of the steps that were then taken, especially as Judy Shelton rightly stressed, destroying the monetary system made an already extremely difficult task even more difficult.

And finally, there is the point that if they all agreed that what they had to create was a free enterprise economy based upon pri-

vatization, the task would be difficult enough, but as Mr. Tikhonov well knows, there is not a majority either in the Politburo or I suspect among the people to go quite so far in that direction.

SOVIET UPHEAVAL

Representative HAMILTON. Do you expect to see an upheaval in the Soviet Union?

Mr. NOVE. Frankly, yes.

Representative HAMILTON. Do you expect to see chaos in the Soviet Union?

Mr. NOVE. As I indicated in my comment on the CIA note, what they consider is most likely, which is stagnation and slow degeneration, seems to me optimistic, if the word "optimistic" is applicable in this context.

Representative HAMILTON. Are we going to see mobs in the street in the Soviet Union demanding consumer goods, for example?

Mr. NOVE. I think this may happen anytime somewhere because of the breakdown of the system of distribution; that is, for example, agricultural output may not go down, but in the Urals, let us say, in the main working class centers, if even bread fails to arrive, then there would, indeed, be a riot. I asked this question many times when I was in the Soviet Union. Nobody denies that this is a possibility. The only difference is on the question of likelihood.

GORBACHEV'S DELAYS

Representative HAMILTON. Ms. Shelton.

Ms. SHELTON. Well, your first question concerning the delaying of this latest economic reform plan, I consider that an abdication of responsibility by Gorbachev. It is part of a pattern to talk about the new, exciting economic reforms and then to refrain from implementing them. The key reform deals with allowing flexible prices. This would have been the linchpin of perestroika. Without it, there is no perestroika program. There is no self-financing, no concept of profit and loss, no market. So, I feel that this is maybe the last time that he is able to pull back from doing what needs to be done. So, now I think it is for his personal political welfare, not in the interest of the country.

Representative HAMILTON. Why do you think he did it?

Ms. SHELTON. Fear.

Representative HAMILTON. Fear of what?

Ms. SHELTON. Fear that the public will not tolerate a freeing of prices at the same time that they would have to fix wages because they would feel squeezed intolerably. And at that point, we are talking about social turmoil and, yes, rioting in the streets.

Representative HAMILTON. Do you think he has just postponed it for a few weeks or a few months, or do you think he has postponed it for a long time?

Ms. SHELTON. I think that there is a slide that is inexorable and if he had gone ahead with the program, I think as early as July you could have seen some of these manifestations in the streets when the Communist Party had its big meeting. Now perhaps because there is always a tendency to go with the status quo, he could survive as long as next spring, but I think by then the dete-

riorating economic and financial conditions will catch up with him, and that would be the end of it.

PRESCRIPTIONS FOR THE SOVIET UNION

Representative HAMILTON. I was interested in Mr. Tikhonov's prescriptions as to what must be done for the economy. I am sure you heard them. He talked about radical restructuring, rejecting state monopoly, privatization, deconcentrating production, and a number of other things.

Are you basically in agreement with his prescriptions, or did you find things among his prescriptions that you just would disagree with?

Mr. NOVE. Well, I agree that substantial steps in that direction are essential if a market is to work. The central system is clearly bankrupt, although in an odd sort of way, the reason why there has not been a total collapse since the market is not working is that bits of the central system are still working. This is the tragedy that steps now taken toward marketization in the midst of the chaos will simply reflect the chaos. A whole package of measures requires to be taken, put monetary system into order, and so and so on.

No, basically I agree that this would be a coherent program if it could be politically sold not only, as I say, to the Politburo, but to enough of the people so they would not rebel.

I wrote down as Judy Shelton was speaking earlier the words "domestic price reform is the match that would ignite the powder." If one wants to see why those who also realize this hesitate to introduce the domestic price reform, Judy Shelton has given the reason. At the same time, the risk of igniting exists if they don't do anything on pricing and not only on prices, the slide to perdition will continue.

One last point which is worth mentioning, in discussing with one of the leading reformers in Moscow, he said, "We need a little chaos." By that he means without a sufficient degree of chaos to frighten the leadership into taking emergency and decisive measures, nothing will ever be done. But a little chaos. Too great a chaos, and they will be unable to take any measures.

Representative HAMILTON. Ms. Shelton, how do you look at those prescriptions that Mr. Tikhonov put forward?

Ms. SHELTON. I think they are very reasonable, but we are talking now about the distinction which Mr. Nove made, which is these would be proposals that would work to save the people, but this would no longer be a Soviet system. I think that Mr. Tikhonov's proposals would save the people because they are an industrious people and there are resources in that country.

Indeed, there are goods that I think would come out of the woodwork if there was an orderly monetary system in place, if there were a ruble people trusted. A lot of people having living rooms full of soap and toilet paper and other supplies. They hoard them because the distribution of these goods is so unreliable. You would have a much more efficient, orderly market without the costs of people holding inventory and the accompanying distortions if they believed in the system.

So, I believe the proposals put forth by Mr. Tikhonov would give the kind of inspiration to the people—if they felt these were really being adopted on a national scale—to where they could save that country. But, again, it would no longer be the Soviet Union.

Representative HAMILTON. Mr. Tikhonov, one of the things that impresses me this morning in the testimony of all three of you is that you are really pretty much in agreement with regard to the prescriptions. At least in this country, we have heard many, many economists analyze the Soviet economy. They all come to roughly the same kind of conclusion, that is, moving toward markets and the market-oriented economy in a general sort of a way.

GORBACHEV'S PRECARIOUS POSITION

What does Gorbachev think? What do you think his remedy is for the Soviets? Is that the direction he wants to go, and he is only delaying because of what he considers to be political considerations? Where does he want to go with his economic policy?

Mr. TIKHONOV. As you know, since I know President Gorbachev myself, then I would like to say that it is only Gorbachev who can answer this question.

Representative HAMILTON. I do not want to put you on the spot with any of my questions, Mr. Tikhonov, and I realize some of them are sensitive questions.

Mr. TIKHONOV. Well, I understand, and I am not afraid if you put me on the spot.

Let me say this. Gorbachev's situation is extremely difficult. At the very first stage of his work as leader of the Government, his movements were not decisive which led to the fact that the reform was dragged on for 5 years, and now we can see that it can be postponed to the indefinite future.

During this time, the political prestige of Gorbachev in the entire country has been lost. And at the same time rather powerful conservative forces managed to consolidate, and their pressure on Gorbachev at the present time is stronger than the pressure from the democratic forces. And I think that preserving his willingness to have democratic principles altogether and to have a democratic country in the future, Gorbachev was caught in the trench of two events: First, the increased effect of conservative forces and the danger of mobs out in the street; and second, he was not able to make decisive measures under this very complicated and hard situation.

I think that the only method that Gorbachev can use when taking correct decisions as far as his policy is concerned is the constant and strong political pressure of masses on the core of People's Deputies, on the Government, and of course on conservative forces in the support of Gorbachev's program that he initiated first in 1985–86.

GORBACHEV'S ECONOMIC GOALS

Representative HAMILTON. Mr. Nove and Ms. Shelton, from your point of view, studying what Gorbachev has said and done, what do you think his economic goals are? What is his economic model? Do

you have any sense of that, or has he never really articulated where he wants to go?

Mr. NOVE. He has never quite articulated it, but this is also true of a number of his advisers. Some really want, to put it so to speak simply, to put Russia into Western Europe economically and have a capitalist system with some of the welfare features of, let us say, Sweden. Some would go even further and say that Sweden is too Socialist. I have met such people who argue this furiously in Moscow.

But Gorbachev himself as a leader of the Communist Party is committed to some kind of market socialism. And the question then becomes is this as I think Plekhanov used to say the equivalent of fried ice, is this a possible combination that could work? And most of the East European countries, Poland, Czechoslovakia, and so on, are now dominated by people, many of them former Communists who now say it cannot work and that really you privatize as much as you can move toward some sort of capitalism as quickly as possible.

I do not think Gorbachev, even if he feels it, has ever said it and quite possibly does not feel it.

Representative HAMILTON. Is that your impression too, Ms. Shelton?

Ms. SHELTON. Yes. I think he has tried to compromise, and by saying market socialism, it was his way of talking about capitalism with a human face. It is an oxymoron. And yet he is very committed to the humane goals of communism, and he has asserted, "I am a Communist," and "I believe that we should not give up some of the strides we have made in being sympathetic toward the needs of all members of society." At the same time, he wants the benefits of free markets to improve the economic condition of the Soviet Union, and in the middle of all that, he has to maintain the central role of the Communist Party which is pivotal to his own political survival.

CHANGING THE SOVIET ECONOMIC STRUCTURE

Representative HAMILTON. The Polish people, of course, have gone to shock therapy, and they have decided the only way you get from where they are to where they want to go is to do it immediately. Is that the way most economists analyze the situation? Is that what you have to do to make the transition from the command structured economy to the market economy? You have to go cold turkey?

Mr. NOVE. You can slightly warm the turkey, but otherwise I think you are right.

Representative HAMILTON. What do you mean slightly warm the turkey?

Mr. NOVE. I will explain. Gavriil Popov, one of the leaders of the radicals, has this notion, which was mentioned, is not exactly soup kitchens. His original notion was that you keep a kind of rationing system. Everybody has coupons which can be turned into some consumer minimum at the fixed price and put everything else on the free market, including anything over and above the coupon of the items that are rationed. That was his formal proposal. It has been

supported by several. And that is what I mean by saying that while the turkey must be cold, nonetheless bits of it should be sufficiently warm to prevent people from rioting in the streets. The majority of his colleagues said it is not practical, one of the reasons being that they would be incapable of administering such a scheme.

Representative HAMILTON. Ms. Shelton.

MODELS FOR REFORM

Ms. SHELTON. Yes. The Soviet economists are very intrigued with what the Poles are doing, and they have gone over to study it, and Nikolai Petrakov in particular. I think he found the idea of moving to a cold shower appealing because he is a theorist, a monetary purist, and he liked it as an academic exercise as much as a political move. But Nikolai Shmelev said unfortunately the Soviet Union could drown in such a shower.

There are other models. The Poles are in an experimental phase, and it seems to be working for them. But the jury is out on that.

Representative HAMILTON. What are the other models?

Ms. SHELTON. Well, for instance, Bulgaria has decided to do nothing while they just review everything, and then they will decide in the future what they should change, what they should not change.

And then there are models in between. Hungary is still doing a kind of hybrid approach. They have not made the commitment to free markets and democracy that the Poles have made.

Czechoslovakia is still feeling around, I think. They are concentrating more on moral direction and the political system of the future. Economically I think they are still testing the waters and maybe thinking of setting up some kind of regional power base with Poland and Hungary.

So, it is the Poles who have done the most radical thing and it is not clear if that will turn out to be a good model to emulate.

IMPLEMENTING THE PRESCRIPTIONS

Representative HAMILTON. Mr. Tikhonov, from your point of view as an economist, do you think the way to go at the prescriptions you have set forth is the dramatic, abrupt change rather than a slower or a warmed turkey, as Mr. Nove talks about?

We are really going to get him mixed up with that translator in a minute, aren't we? [Laughter.]

Mr. TIKHONOV. First of all, if we want to have that dramatic shift, it should be a radical disassembly of the Soviet system as it exists today. And this purpose must be proclaimed not only in the general concept, but in the overall program of perestroika.

The goal of the program should be the transition to the system of free enterprise and a market-oriented system, but this program has to be implemented step by step, and it is not going to be a very fast process.

So, let me emphasize again which I said before, that the first step is the concentration of resources and creation of small business enterprises and small business system. And the transition to the system of nonregulated—no, not nonregulated but nongovernment regulated, government-owned prices with the application of

clining creditworthiness. Especially now as they are actually missing payments to suppliers.

McDonald's is seen as a successful business venture in Moscow, but remember, they are only getting rubles there, largely worthless rubles. So, I think it is better characterized as a popular soup kitchen.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Mr. Chairman, this has been one of the most remarkably interesting hours I have spent in 25 years in Congress. I deeply regret I had other commitments that made me so late.

Mr. Tikhonov [Russian spoken].

The INTERPRETER. Mr. Tikhonov, I am happy to meet with you. [Laughter.]

Representative SCHEUER. Thank you.

SHORTCOMINGS IN BOTH THE U.S. AND SOVIET SYSTEMS

Your testimony itself and the fact that you don't fear for your life is an eloquent symbol, as you are an elected official now, of the profound, almost unbelievable, inconceivable changes that have taken place in the Soviet Union in the last year or two under Mr. Gorbachev's leadership. And having a person like you elected to a legitimate parliament and coming over here and speaking with such authority in such a forthcoming and candid manner, it is unbelievably refreshing and encouraging. And there ought to be a way that through our mutual science and technology we could clone you. I thoroughly enjoyed all of the testimony.

Mr. Chairman, with your indulgence, I would like to sort of take the sense of the meeting and apply it to the great problem that I see our two societies facing, which is that we still seem to be locked, our country into a $300 billion military budget, and the Soviets are locked into a society that seems to be increasing its expenditures on the military or certainly not reducing them significantly to the best that we can see.

We are suffering. We are undereducating our kids. There are 30 million Americans who we exclude from health care in our country. We do not give our senior citizens long-term care. We do not give them catastrophic care. We are 20th in the world in infant mortality. Our infrastructure, our roads, our bridges, our tunnels, our sewer systems, our water systems are at the point of collapse. Our urban hospitals are at the point of economic collapse because our health care system is in such disarray. We spend 50 percent more for health care as a percentage of our GNP than any other country in the world. We spend twice as much as Japan, and yet we are depriving major segments of the American economy of health care. Our hospitals themselves are at the point of financial collapse. In other words, our society has enormous—enormous—unmet needs.

Now, you folks have described the Soviet society as almost incapable of providing the daily needs of subsistence, of survival for a country of 280 million people. I would like to translate that into some kind of guidance for 535 Members of Congress as public policy decisionmakers, of a President and a National Security

Council that has to digest all this and come out with some direction for us.

VIABILITY OF THE SOVIET THREAT

What do you think our National Security Council, which is the strategic arm of the presidency—what do you think the experts, the military and the intelligence experts, at our National Security Council should be telling our President and our Congress about the likelihood and about the physical ability of the Russian society, the mindset of the Russian general staff, to wage an important military attack on us, a nuclear attack? That is the only explanation for our $300 billion military budget.

Is the continuation of this military budget an act of absolute delusion and fantasy and waste beyond the comprehension of the human mind rooted in real concerns, real strategic and military concerns, that there is a prospect of an attack that would justify the order of magnitude of our military expenditures, $300 billion a year?

If I could point at you and say you are the strategic national security adviser to the President of the United States for 10 minutes, what would you tell him about the need, the desirability, the sensibleness of our present military posture and our present budget that he is trying to get through the Congress right now of a $300 billion military budget, including $5.5 billion for the B–2 Stealth bomber, $4.7 million for Star Wars, $2.5 billion for another system of moving nuclear bombs around on railroad cars? What would you tell him of the relevance of this mindset that we seem to be frozen in to the realities that exist in the Soviet Union?

Mr. TIKHONOV. When you asked your question, you made me think whether I should candidly say what I think or should I speak from the standpoint of an official officer, and you reminded me that I am official person.

Representative SCHEUER. But I think part of the great value of your testimony today is that you have been so unbelievably candid and truthful and honest and courageous in your remarks to us, so forthright as to have earned you a death sentence if this speech had happened a few years ago. So, please continue in your present courageous, forthright, highly thoughtful manner.

Mr. TIKHONOV. Thank you.

Representative SCHEUER. Mr. Tikhonov, I have stipulated that for the next 10 minutes, you are the national security adviser to the President of the United States. Now, that is a slight different role for you. Advise our President candidly and advise our Congress how you perceive of the long-term level of military threat by the Soviet Union to the United States, to our security interests, to our survivability as a nation. What is the likelihood of a major military attack that could justify our present level of $300 billion a year military budget?

And to encourage you to be candid, I will report to you that the head of our CIA, Mr. William Webster, has reported to Congress and the world publicly that he thinks the changes that are taking place in the Soviet Union are irreversible. Former Secretary of Defense MacNamara testified that he thinks we ought to be on a

downward glide path that would cut our military budget in half in 10 years. A four star general, Andrew Goodpaster, who was the commanding general of our European forces, forces in the European theater, in World War II and a lifelong, career, long-term strategic planner, said that we should be on a downward glide path to cut our military budget in half between 5 and 10 years.

So, taking all of that into account as part of the background music, give the President your long-term strategic advice as to how we should evaluate the threat of a major military confrontation with the Soviet Union and what that means for our $300 billion military budget and all of the unmet needs in our society that are literally crying out for attention?

Mr. TIKHONOV. Let me put it this way. No. 1, never in the near future will there be a likelihood of the situation that the Soviet Union would attack the United States.

Now, No. 2, are local conflicts possible? My answer is, yes, they are possible, but only under the circumstances that the democratization process in my country would collapse and unless Gorbachev would not find himself in the mesh of the pressure from the conservative forces that he always feels.

And if due to the irreversible and mistakable decisions taken in the economic front, our government would provoke some undesirable inside the country from the people, then the ethnic confrontations and wars between nationalities inside the Soviet Union would even grow. Then the economic strikes of the workers will become political strikes. Then the Government will have to apply three major forces that it has not yet used. These are the army, KGB, and Minister of Interior Affairs. If something like this happens, then the danger of the military conflicts with the kind of participation of both the United States and the Soviet Union would be quite real.

Then if I were an adviser, I would tell your President this. Let us use our all-possible ways, including moral and ideological ways, to support the process of democratization in the Soviet Union.

Let us precisely and correctly express our attitude toward the Soviet-Lithuanian conflict. Let us express our ideas of what we are going to do when next after Lithuania, we will have Estonia and Latvia on that path. And then we would be able not only to say no to our defense department for $300 billion, but also to make it, the Defense Ministry, to adopt the program that will lead to the reduction of military expenditures and military forces.

But then I would say, Mr. President, if you don't want to do this, then you should bear in mind that the current stage of the collapsed economy of the Soviet Union did not destroy the Soviet industrial power because as of today, it has not touched the Soviet military monopolistic power.

Well, I have to apologize. I was speaking in a very sincere manner. That is why maybe it was a little bit not that direct of a statement.

CONCERNS ABOUT LITHUANIAN SITUATION

Representative SCHEUER. Well, I appreciate it very much. I must say that while the President and I may differ on some matters, I

believe he has been totally supportive of Mr. Gorbachev and the leadership that he is giving to democratization in the Soviet Union.

And I believe he has expressed great concern about what is happening in Lithuania in the hope that the Soviets will act with great restraint and not induce a violent situation that would result in the death of many innocent people. He has been forthright and has articulated the concerns of the American people.

Mr. TIKHONOV. If it is possible, I would like to add something.

Representative SCHEUER. Oh, yes.

Incidentally, may I say to the other two witnesses I am going to ask you substantially the same question I asked Mr. Tikhonov a few minutes ago. So, think about it.

Yes, Mr. Tikhonov, please. [Russian spoken.]

The INTERPRETER. Please.

Mr. TIKHONOV. Well, I would like to express here in this room quite firmly all of us—I belong to the democratic force of the Soviet Union—we all support Gorbachev and his democratization program. But we do not appreciate the fact that instead of dialogue with Lithuania, he uses violence. And our democratic forces are not strong enough perhaps that Gorbachev would not realize that the prestige of state depends not on the fact that you want to preserve your colony. So, whether the dialogue is going to take place or not, this is an open question. But the deterioration of the situation with Lithuania is a real fact of today.

Representative HAMILTON. Excuse me, Mr. Tikhonov. I have had an interruption here which will require my leaving the hearing. I regret that. I think we have had, as Congressman Scheuer said a moment ago, an outstanding hearing. I still have a long list of questions here, but I will not be able to get to those. It is probably good fortune for you that we don't get to them.

But I want to express my appreciation to each one of you for really an outstanding hearing this morning. We are deeply indebted to you. Thank you very much.

Representative Scheuer.

Representative SCHEUER [presiding]. Thank you, Mr. Chairman. Please proceed.

Mr. TIKHONOV. Thank you very much. This is all I wanted to say.

VIABILITY OF SOVIET THREAT

Representative SCHEUER. I would like to ask the other two witnesses really the same question that I originally asked Mr. Tikhonov. If you were national security adviser to our President, knowing what you know about the economy of the Soviet Union, and knowing what you know about the concerns, the anxieties of the people, knowing what you know about the likelihood that the general staff of the Soviet armed forces, who are very brilliant, very professional and very conservative, could look at the country, could look at the events going on in the length and breadth of their country and concede that it would be in their country's interest to launch a major military attack against the West, specifically the United States, what would your advice to our President be as to the likelihood over the next 5 or 10 years that we should really be

in a state of readiness for such an attack because that is what a $300 billion budget is all about?

A $300 billion budget is not about an occasional regional conflict in Afghanistan or Lithuania or Nicaragua or wherever. A $300 billion military budget is about a major nuclear confrontation with the other superpower. That is what it is all about. We could cut our military budget in half if we could be assured that what we are talking about is the kind of regional conflicts, the Middle East situation, Afghanistan, Nicaragua, Lithuania, and the like.

So, just pretend that you are talking to the President of the United States and you have 10 minutes to do it. What would you tell him?

Mr. NOVE. I would say, agreeing entirely with Mr. Tikhonov, that such a probablity is really infinitely small. I would add that it was probably small even before, although the Brezhnev policy of military buildup certainly occurred. A number of our Soviet colleagues have told us that Marshal Ustinov, when he was secretary for defense, took so much time it is one of the explanations for the weakening of the Soviet economy.

Representative SCHEUER. Of course, that is exactly what is going on in this country.

Mr. NOVE. Yes, right.

But the whole atmosphere of discussion on foreign policy in the Soviet Union has become transformed in recent years. Their own errors in their own military buildup and in their policy in Afghanistan have been very roundly condemned by the Soviet press itself. And the thought that now anybody, from the chief of staff of the Soviet Union downward, is contemplating a scenario involving an attack on the United States seems to me entirely fantastic.

However, I will only add one point. If Gorbachev were subject to pressure from right wing Russian nationalists— and I read the stuff they write sometimes with dismay—my impression of them—and I do not know if Mr. Tikhonov who perhaps knows them would agree with that—is that they are isolationists who would turn inward. They are concerned with the development of Russia along some mysterious Russian-Slav mystic path. You take, so to speak Dostoevsky and Solzhenitsyn, Solzhenitsyn above all—he is the typical of such thinking. He is one of their gurus now, although he is still in Vermont. Shake Dostoevsky and Solzhenitsyn well, and out comes a doctrine which is not an offensive doctrine except to non-Russians living in Russia.

It is not a doctrine either contemplating attacking the United States or even would contemplate the reconquest of Eastern Europe. I am sure the Poles, who after all are very much closer and feel more vulnerable, would agree with that. They do not really expect that any Russian Government would invade them and overturn their present independence which we so welcome.

Representative SCHEUER. Well, I suppose that the reason that you have the present Czech Government and the present Polish Government and the present Lithuanian Government and the present Bulgarian Government and the present East German Government is that, to his very great credit, Mr. Gorbachev told them—I don't remember whether it was 6 months or 1 year ago—you have to deal with your reform movements in your own way.

But the one thing you cannot expect is that Soviet tanks are going to roll into Czechoslovakia as they did in 1968, that Soviet tanks are going to roll into Hungary as they did in 1956. Just don't expect that the Soviets are going to send their military power to suppress any local reform movement. And I think we all owe Mr. Gorbachev a great deal of gratitude for that.

CHANGES IN EASTERN AND CENTRAL EUROPE

But this now is the situation that prevails. From the point of view of many of us in this Congress, the situation in Eastern and Central Europe is one of democracy moving at a pace that none of us would have conceived possible a year ago, the domino, one government after another in a matter of days and weeks and months, the Baltic countries—well, Mr. Tikhonov, we have signs in this country in a big room like this and it says, in the case of fire, walk, don't run to the nearest exit. Well, these Baltic countries are running, not walking to the nearest exit. Maybe they were a little bit overprecipitant. Maybe the instant declaration of indpendence in the light of what has happened in the last few weeks may have complicated matters.

But they all seem to be moving out. The eastern and central countries are establishing their own democracies, moving toward elections. It is hard for us to visualize the former Soviet empire mobilizing itself for a military attack. And I think you have spoken very thoughtfully and very eloquently on that subject.

Do you have any further remarks on that matter?

LITHUANIA

Mr. TIKHONOV. I would like to touch upon one problem. I personally understand the reasons why Lithuanians are so impatient because I really visualize what kind of 50 years before today they had during which—the 50 years—they could not get their independence having lost it before. And the fact that their statement was that they want to leave the framework of the Soviet Union without waiting for the constitutional law about the orders how they should do this, I understand that as well because the law of secession from the Soviet Union we all know in our country is the law of non-secession from the Soviet Union.

So, I myself and my colleagues, my friends, do support the decision of the Lithuanian people and the Lithuanian Parliament. As far as I am concerned, the major concern is what would be the public opinion in the world along this line and whether it would be supported consistently.

Thank you.

VIABILITY OF THE SOVIET THREAT

Representative SCHEUER. Let me ask Mr. Nove and Ms. Shelton to address the same general question.

Mr. NOVE. About Lithuania specifically or——

Representative SCHEUER. No.

Actually you started. Conceiving yourself for 5 or 10 minutes as national security adviser to the President and summing up the willingness, likelihood, the advice that the general staff is giving to

Mr. Gorbachev, what would you advise the President to be thinking about and discussing with the National Security Counsel in the weeks and months ahead that would give him guidance on our $300 billion military budget?

Ms. SHELTON. Well, I think we should be grateful in a sense to the Soviet Union because they have demonstrated a very valuable lesson for us as well, which is that you have to have something left to defend, and if you devote too large a share of the economy to military power, then you may in the process destroy the economy and defeat the purpose. Now, the Soviet Union has been spending over 25 percent of GNP to support the military, and the lesson they have demonstrated is that is not a viable way to operate, that eventually the economic structure crumbles under such a heavy burden.

Representative SCHEUER. I would remind you it is certainly not desirable. The State of Israel spends between 30 and 35 percent of its GNP on defense, and although they have a very difficult economic problem, it is a tolerably acceptable standard of living.

Ms. SHELTON. I think that in Israel's case it is justifiable. I think that they are at risk geographically and politically.

I think the Soviets felt they were at risk when they were not. I don't think there was ever much of a chance the United States would attack them.

We felt we were at risk from the possibility of Soviet attack. We devoted about 6 percent of our GNP to defense, enough to feel sufficiently protected, although we came away from a position of having offensive powers to settling for a parity level. So, I think we have always tried to have minimum defense needs. And it is encouraging to think that perhaps there is a reduced Soviet threat now and that we can reduce defense expenditures accordingly.

But at the same time, during this period of instability in the Soviet Union, while there may be less chance of a premeditated attack initiated by central military staff, there are other possibilities to be concerned about. There are strong missile launching capabilities concentrated, for example, in Kazakhstan, which is the republic that borders Azerbaijan, in that region. It is a Moslem area, Islamic. You could possibly have some kind of nationalist sentiment not emanating from Moscow, but local, that would pose a security risk to us. So, we may have to reevaluate the nature of the defenses that we have to maintain, but we certainly should not let down during a period when so much is unpredictable. And I think a significant military risk is still there.

Representative SCHEUER. You would say that the basic factor of instability in the possibility of a wide variety of unexpected happenings is sufficient justification for us to keep our guard up.

Ms. SHELTON. I defintely would. At the same time I think you have to reevaluate the character of our total defense machine which maybe had been primarily oriented toward the possibility of a full-scale attack or somthing initiated through corridors in Europe, and we were prepared to defend with troops and tactical weapons in that arena. Now, I think we maybe have to look at the possibility of maverick launchings from isolated republics, and whether this would be more expensive or less expensive, I couldn't venture a guess.

Mr. NOVE. Can I just comment on this because there has been a lot of noise from Kazakhstan precisely about the location in Kazakhastan of all these nuclear installations. But the nature of the noise is take the damned things away, not we will launch them. Why should they ?

Representative SCHEUER. I suppose what you are implying is that if they were to launch them, they would certainly expect to have counterlaunches from us which would destroy those facilities and perhaps the rest of their society too.

Mr. NOVE. Well, no. My point is that the Kazakh nationalists—and they also exist—are saying there are all these damned installations put there by the Russians, which among other things prevents us from pasturing our sheep in wide areas where customary sheep were pastured. Take the missiles away. They were not contemplating using them, of course. They merely say put them some other place if you must have them.

Representative. SCHEUER. Well, thank you very much, and I hope you were not uncomfortable in the role of national security adviser to the President of the United States.

FOOD SUPPLIES AND THE STATE FARMING SYSTEM

Mr. Tikhonov, you have been making dire warnings about the possibility of a severe food shortage, even famine, in the U.S.S.R. What are the prospects of the food supplies and what is the future as you would contemplate it of the collective and state farm system? Will the Government enlarge the role of private farming? Will they make further investments in improving agriculture infrastructure? Give us a view on the future of the Soviet farming system, collective versus private, whether they are going to continue to meet the food needs of the Soviet people, the future of the infrastructure there? Can it be improved?

Mr. TIKHONOV. Unfortunately, today I cannot tell you anything positive about the situation. Today, we have not managed to overcome the monopoly of state farms and collective farms. Perhaps we should expect that next year and the year after there will be no dramatic changes in the food supply system and in the food delivery and food consumption system in the the Soviet Union. Unfortunately, we should perhaps expect deteriorization of the food situation in the Soviet Union by the end of 1990.

There is only one way to get out of this crisis situation. Creation of conditions for free enterprise of individual farmers and individual farmers' plots. It was for the first time during all the years of the existence of our state that in the law on land we managed to incorporate the right of the Soviet farmer to own the land. So, formerly a peasant got his right to have his individual agricultural plot with the application of a restricted number of some outside labor force, but in reality this law has not been implemented yet and perhaps will not because 227 million hectares of land, 99 percent are allotted to collective and state farms, and collective farms and state farms do not want to give up their land and to give their land to the farmers.

I have never been in favor of any violence at all, but I think that in this case the Government should take very strict and very

severe measures for the transfer of this land to individual peasants. If we manage to implement such land reform this year, there is a hope that next year the food situation in the country will be stablized and in another year or two it will even improve.

WORST-CASE SCENARIO FOR THE SOVIET ECONOMY

Representative SCHEUER. Let me ask all the panel a question about the general economy and let me ask you to take what we call, Mr. Tikhonov, a worst-case scenario. How bad can the situation get? How bad is it likely to get in the next couple of years in terms of production disruptions, in terms of unemployment and inflation? Could there be a free fall or a deep recession in the Soviet Union? Is the Soviet Union in a recession now, and is a deeper one likely for the rest of 1990 and 1991, for all of you, anybody?

Mr. Nove.

Mr. NOVE. The possibility of the disaster scenario is excluded by no one. I was in the Soviet Union for the last couple of months of last year. I put this question repeatedly. Nobody—nobody—that I spoke to—and I have spoken to 30 or 40 quite reasonable people—would deny the possibility of a total breakdown in the system with regions each going their own way, some holding onto food which the others could have and so the others are going hungry, the supply system breaking down, production breaking down, oil deliveries to abroad impossible to make because of strikes in the oil industry. You can devise a scenario—indeed, there is one in Judy Shelton's prepared statement, too—as a possibility.

The basic question is the degree of possibility or probability of such a thing happening bearing in mind that when it starts happening, it concentrates the minds of the leadership wonderfully and they may have to do something. So, yes, such a thing is possible. If one had to put a mathematical number to it, I would hastily dodge and try and discuss some other subject.

Representative SCHEUER. Ms. Shelton.

Ms. SHELTON. Well, in terms of declining economic prospects, it has been noted that in the first 2 months of this year, there have already been more man-hours lost in the Soviet Union due to strikes than there were for all of 1989, which you recall was characterized by the very serious miners' strike in Siberia. Production has been declining at a time when wages have gone up 15 percent in the first 3 months of this year. So, you are exacerbating the whole problem of excess money in the system, and now, it's on a lower base of production. So that indicates more shortages, more hoarding, and all of the things that pull down the performance of the economy.

I think the worst-case scenario is the most likely case. And I think the Soviets are on the verge of hyperinflation, especially since they have backed away once again from what I saw as a last ditch effort to try to get back on track with the whole idea of economic reform.

I will repeat. I think that you could see social turmoil manifested as early as July during the Communist Party conference.

Representative SCHEUER. This year.

Ms. SHELTON. Yes. And I think that, though Gorbachev has put off this explosive area of price reform for now, it will catch up with him by this time next year due to declining grain supplies and the now precipitously falling standard of living. All of this is very perceptible to Soviet citizens.

Representative SCHEUER. You think that the worst-case scenario is a likely prospect.

Ms. SHELTON. Yes, I do. I do not see a way out at this point.

Representative SCHEUER. Well, that is a very sobering prospect you have given us.

Would you like to comment on that appraisal of Ms. Shelton's that such a worst-case scenario is a likely prospect at the present time?

Mr. TIKHONOV. Unfortunately, I think that Ms. Shelton and Mr. Nove are very close to reality when they speak this way. Yes, such dangers are quite real. But I would like to attract your attention to the fact that this danger is in no way an economic danger. So, the worst-case scenario, if it happens, would not be the strikes and demonstrations of miners, of workers.

The worst-case scenario would be the fact that the Government would use this for political purposes to oppress the democratic movement in the country. Unfortunately, we cannot guarantee that such danger will not happen.

Representative SCHEUER. Well, you are saying it would affect the process of reform and the viability of your democratic parliament.

WILL GORBACHEV SURVIVE?

What would the effect be on Mr. Gorbachev of a severe depression, on him and his political leadership and the group that is advising him? What would the likely implications be for his political viability and his political survival? Would he be as much threatened, in other words, as the viability of your newly formed democratic instituation, your parliament?

Mr. TIKHONOV. It will depend, of course, on the ratio between the conservative and democratic forces in the country, and it will depend on the fact which chair, the left chair or the right chair, will Gorbachev select when such ratio is determined. Did you notice that many times here I spoke about the formulation of the public opinion on the democratic movement in the U.S.S.R.? Let me emphasize again that this will largely affect the ratio, the correlation, between the democratic forces, including their influence on Gorbachev himself.

Representative SCHEUER. Do either of you two care to add?

Mr. NOVE. I agree. This is extraordinarily difficult to forecast what he will do. The thought that always occurs to me is this. What has happened in the last years has been a decline, which we welcome, of the power of the Communist Party regime combined with the decline of power in general, its ability to organize, its ability to secure obedience, and its own self-confidence in doing anything. They are in a very serious situation, and paradoxically although a dictatorship is a bad thing, some firm power is necessary to carry through anything, including the reforms envisaged by Mr. Tikhonov. And we have reached a situation now——

Representative SCHEUER. In other words, the very success of glasnost and perestroika requires some leadership and some ability to direct the workings of society and the economy.

Mr. NOVE. Yes, and one would add that all the things that we welcome so much that you, sir, have also commented on, the freedom of speech that we see that is in the Soviet press and the media daily, are excellent. Free elections, unheard of for 70 years, excellent, but in a certain sense it is also an obstacle to carry the reforms through.

PROSPECTS FOR A POGROM

Representative SCHEUER. Let me give you just a particular certain sense that some people in the United States are concerned about, the freedom of speech, the relaxation of controls, the unloosening of the 70-year-old structured control, tight control of a society. Pamyat has announced just in the last month or 6 weeks that they plan a pogrom and they have even given us the date. The date is going to be May 5. I think that is Lenin's birthday.

Now, I guess you would have to say one of the unexpected consequences, at least for most of us, of perestroika, restructuring, and glasnost, which in openness, is this freedom of speech, is this relaxation of controls, which now may be unleashing dark forces in the Soviet zone. The forces of violent antisemitism were not a product of the Communist Party since 1917. This goes back to the last century. The distribution of the Protocols of Zion, that hateful and obscene work that talks about blood sacrifice and awful allegations about the Jewish people, purely mythical, now are being propagated. There has been overt talk, as I say, of a pogrom on May 5.

How is Mr. Gorbachev going to manage that? To what extent is the present progression of glasnost and perestroika, both the freedom of speech you discussed which we heralded with such delight, which we received with such delight, and the reduction of structural controls over a society and all of its people—are they going to let this dark, ugly underbelly of Soviet society rampage through communities and cause the depth and violence of the pogroms of the last century?

Mr. NOVE. Yes, indeed. Some strange things are being said and written. There is a writer who even says that collectivization of agriculture was forced on Stalin by blackmail by the Jews, which is a most amazing way of writing Russian history.

Yes. What can one do about it? Freedom of speech involves in a country with these sort of traditions the possibility of these things coming to the surface. Whether in fact there will be a pogrom on May 5 is anybody's guess. I have heard a number of competent people say that the fears are exaggerated. We shall see on May 5.

Representative SCHEUER. Yes.

Any response from anybody else? Yes, Ms. Shelton.

Ms. SHELTON. I think to a certain extent Gorbachev is accommodating that kind of sentiment because it is emerging as a powerful force in the Soviet Union. Now, let me just make a distinction.

Representative SCHEUER. Do you want to elaborate on that?

Ms. SHELTON. Yes. Well, for instance, he just put two people on his 16-man cabinet—this is the first cabinet there has been in the

Soviet Union that is above the Supreme Soviet in advising Gorbachev—who are associated with that movement. One is openly a leader of Pamyat and the other is a writer who is seen as reasserting this great Russian spirit and sort of forgetting the mistakes of 70 years and trying to get back on track where they were with Stolypin around the turn of the century before communism took over the destiny of Russia.

Representative SCHEUER. He did include several members of Pamyat outspokenly, violently antisemitic in a press delegation, a press and cultural affairs delegation, that he sent to our country only in recent weeks.

Ms. SHELTON. Well, there is a tendency to think that the great Russian types are automatically antisemitic, and that is not the case. You have to separate that out. It is not necessarily evil that some people want to go back to the natural destiny of their country before communism took over. To be a Russian nationalist does not mean that you are automatically antisemitic or anything else. Nationalism can be an admirable thing.

So, I am saying that Gorbachev is very adept in——

Representative SCHEUER. Can one be a supporter of Pamyet and stand only for the kind of admirable and healthy nationalism that you are describing?

Ms. SHELTON. I would say Pamyet is an extremist group that is not healthy.

Representative SCHEUER. Well, these people were members of Pamyat, outspoken supporters of Pamyet.

All right. No matter. Go ahead.

Ms. SHELTON. Well, my point is that I do not think Gorbachev is a force for good who is opposing these kinds of ugly aspects, nor is he necessarily—he is certainly not aligned with them. But he will use political support where he sees it, and he sees support from the democratic Russian movement which has taken over the councils of Leningrad and Moscow.

I recently saw a portrayal of Yeltsin in the form of an icon. This is very symbolic of that old Russia nostalgia, that feeling that there was something great that has been lost under communism. Many people see Yeltsin as the banner of a revolutionary movement. And so, in that sense, Yeltsin is a threat to Gorbachev, and that may be why Gorbachev put two people associated with that same movement on his cabinet.

SOVIET ECONOMIC COLLAPSE

Representative SCHEUER. Let me ask all of you to project this thinking of a serious depression, a free-fall depression, in the Soviet Union, literally, virtually the unraveling of the Soviet economy. If this happens as, Ms. Shelton, you say is a likelihood—we have discussed what the effect will be on Gorbachev—what will the effect be on the Soviet's trading partners, and what will the effect be on the newly emerging democracies of Eastern and Central Europe? Will this be a threatening phenomenon in terms of their smooth transition to democracy of Eastern and Central Europe? Any of you?

Mr. TIKHONOV. These are very sharp and deep questions that you are raising. In our country, we have an opinion like this, that these are the poor people that are always aggressive. So, the decline of the economy, which is caused by the existing social system of the U.S.S.R., is a danger to the whole world and in particular to the people of Eastern Europe. On the other hand, the reforms that we are trying to implement, as far as I am concerned, are the only way to get out of the situation of beggardness in our country. Thus, whether these reforms are successful or unsuccessful actually depends on the future of, in particular, Eastern Europe.

Let me emphasize again that the economic decline of the Soviet Union is not an absolute decline. This can be regarded as an absolute failure of the consumer sector with the preservation of the industrial complex that has been all those years the backbone of the preservation of the state. So, I would like to emphasize that the industrial complex is not deteriorating, is not collapsing, and it can exist for a long time based on the very poor situation of the people.

Mr. NOVE. May I just for once disagree?

Representative SCHEUER. In other words, you could have a muscular, productive industrial complex in the Soviet Union existing alongside of a very poor consumer sector. Is that what you are telling us?

Mr. TIKHONOV. Exactly.

Representative SCHEUER. And not only a muscular, productive industrial society, but also if the decisionmakers decide that way, it could be a muscular, productive military industrial sector. So, you could have perhaps growing food shortages, growing unrest, growing dissatisfaction with the people, but concomitantly it is sort of like a Shakespeare play with five concurrent plot lines. You could have increasing military production.

Mr. NOVE. May I please strongly disagree?

Representative SCHEUER. Yes.

Mr. NOVE. In order to achieve such an objective, you need Stalin and the terror. Stalin and the terror did achieve exactly that. I do not see Stalin, and may I confidently forecast a steep decline in the production of Soviet heavy industry in 1990.

Representative SCHEUER. Including armaments?

Mr. NOVE. Well, arms are going down anyway, but I mean precisely——

Representative SCHEUER. No, they aren't going down, not according to our CIA. They went down in 1989 I am told for the first time.

Mr. NOVE. But I mean, the things is that the announced plans specify, of course, a reduction in arms production, and from time to time we are shown factories that have been converted to civilian use. I think that is genuine.

What I have in mind is that the old sacrosanct areas of energy, steel, et cetera are on their way down.

Representative SCHEUER. With declining production of energy and steel.

Mr. NOVE. Energy is down. Oil production may be in danger also of collapse with most profound consequences for trade incidentally because since by far the biggest Soviet export is oil, the threat is obvious.

Representative SCHEUER. Yes.

Some argue that as we contemplate the disarray in the Soviet economy and the Soviet society, we should not rush to their aid. It is not in America's interest to rush to their aid, that we should perhaps even withhold Western credits on the theory that money is fungible, capital is fungible, could be used directly or indirectly to preserve the Soviet economic system and therefore to preserve Soviet military and industrial power.

How do you all react to that argument?

Ms. SHELTON. That is an argument that I have made. I have felt strongly that it is the unrest among Soviet consumers, who are tired of the pattern of giving first priority to the military, and then second, to fixed capital investment. They get only what is left. They are tired because they have now been squeezed so hard to support the military that they are resisting. That is the impetus, the catalyst for all of the political movement that we are seeing. I have always felt that it would be a mistake for the West to interrupt this process which was forcing the Soviet Government to move away from giving primary status to being a military superpower rather than attending to the needs of the people. They have been so long out of balance as arguably the strongest military power in the world at the same time that the standard of living of the Soviet people was ranked by Soviet economists, based on a basket of goods, as 45th or 50th in the world.

I think it is about time that they try to bring these things back into some kind of reasonable balance. It is the pressure from the people, this economic pressure, that is finally forcing the Government to make the transition; to convert military facilities, to move those resources out of that sector and into the productive consumer sector. I would hate to interrupt that process or give the Kremlin a reprieve by supplying goods from the outside, which would then allow them to continue to have internal scarce resources flow to the military.

Representative SCHEUER. Mr. Nove, do you wish to respond to that?

Mr. NOVE. I do take a different view not because one wants them to devote more resources to the military, obviously not, but because the forces that Judy Shelton would like unleashed have been unleashed. Government policy has changed. I am not proposing some kind of great Marshall aid package for the Soviet Union, but rather that the processes that are going on are basically processes that we should welcome. In that case, at the very least, we should not obstruct them by making life more difficult than life already is.

Representative. SCHEUER. You two have to get your act together.

U.S. FOREIGN AID TO THE U.S.S.R.

Under what circumstances should we propose a significant level of foreign aid, Marshall plan aid, if you will, Mr. Nove, to the Soviet Union? At the present time, during the straightened circumstances of the Soviet economy with the overwhelming desire of both the American people and the Russian people to get on with the business of cranking down their military machines and cranking down the production of military hardware of all kinds—there is

no question that the Soviet people and the American people are absolutely as one at that. But our administration is not really responding the way many of us think it should, and neither is the Soviet's.

That being the case, under what circumstances should we crank up our economic aid and credits and so forth to the Soviet Union, and under what circumstances should we crank it down and turn off the spigot?

Mr. NOVE. If I can just make the point that at no point in anything that I have ever written have I advocated any massive aid to the Soviet Union. The argument I am responding against, so to speak, is the one which says let us obstruct as far as it depends on us; for example, don't give them MFN; for example, prevent the shortening of the list of items on COCOM; for example, make difficulties in the granting of commercial credit because it would further straighten their circumstances, and this is in our interest. This is the argument that I do not agree with.

But there are so many calls on aid now from countries, from Poland to Nicaragua, inclusive, I would not put the Soviet Union high on that list. And the country is so vast that anything we do will make very little difference. Fundamentally it is their responsibility to get their own house in order.

Representative SCHEUER. Right.

TECHNOLOGY TRANSFERS

And how about COCOM? You mentioned COCOM. There are countries in Western Europe that feel that our policy of trying to restrict high technology from going into the Soviet Union because it aids their military machine is ill advised, and they believe we ought to either reduce or relax entirely limitations on high technology going into the Soviet Union. How do you appraise that situation?

Mr. NOVE. I am not a specialist on COCOM. My feeling is that the list is too long. I go along with my fellow Europeans in thinking that some items on the list look frankly rather silly.

The other thing is that the Soviet economy in its present state is guaranteed to misuse almost any technology and that the danger therefore is minimal of their actually making any difference. Obviously, there are some specific items of direct military end use. That is another subject.

Representative SCHEUER. Yes, but we have agreed that the Soviet industrial complex can continue cranking away at a high level and the Soviet military machine can continue producing and prospering, so to speak, while the standard of living of the Soviet people is constantly eroding. While they are even approaching this free fall, full-scale depression, the economy and the military seem to be relatively exempt from that.

Mr. NOVE. I do not frankly believe that.

Representative SCHEUER. Tell me why.

Mr. NOVE. Of course, the traditional priorities are still there, but some of the items on the list really do seem a little odd. I remember, for example, that we had embargoed computer cash registers which were going to be used in a Hungarian supermarket. I realize

the word "computer" is in the sentence, but it did seem a little silly.

Representative SCHEUER. It does, indeed.

Any reaction from either of the other two witnesses?

Ms. SHELTON. Well, I do not think——

U.S. RESPONSE TO THE U.S.S.R.

Representative SCHEUER. On the whole question of the circumstances we should consider seriously enlarging our economic aid credits, MFN and so forth to the Soviet Union, and under what circumstances should we play our cards rather close to the chest and say, look, you've really got to bite the bullet yourself? You have to make some hard choices yourself as to whether your resources are going to continue going into a high level of military production or whether you are going to listen to what your people are telling you, that they want some of these capital investments and cash-flows diverted to satisfying this vast level of unmet consumer needs.

Mr. TIKHONOV. First of all, I am against the policy of giving credits for the development of the mining industry——

Representative SCHEUER. Of which industry?

Mr. TIKHONOV. Mining. Although such investments can prove to be the most efficient one.

Second, the credits in the field of the machine building industry I would use only strictly for certain definite purposes, that is, to acquire technology for the processing industry, first of all, food industry and light industry.

And the third principle is a more general principle. It seems to me that at the present time we perhaps should not develop the economic cooperation while orienting ourselves to the Government structures. What I mean are ministries and large state enterprises and agencies because this way or other, the majority of these investments will land on the tables of the heavy industry enterprises.

During the next 10 years, I would apply the following strategic slogan. Cooperation but only with the nongovernment sector of the economy. I said that this in my statement that we try to develop this sector as an alternative sector and as an additional sector to the state economy.

And we have here an economic nuance that has not been advertised properly yet. I do not know why. That is, the creation of joint ventures for the consumer goods not on the territory of the U.S.S.R., but on the territory of Western countries when a certain share of the manufactured products will be delivered to the U.S.S.R. and the rest will be distributed between the Western countries, industrial countries and developing countries.

It is very important at the present stage due to the following reasons. Such thing as an inconvertible ruble would not be as strong—this factor would not be as strong as it is now. Our undeveloped infrastructure would not be as vivid as it is today, and such a negative factor for any joint venture as the low level of the qualifications and skills of the worker would not be that strong. On the other hand, the credits for the joint ventures do promote the development of the consumer sector in our country.

I am sorry. Maybe I am explaining this in too much detail taking into consideration the fact that we are in the Congress of the United States today. But I would like to emphasize that you should not stay away from the idea of giving us credits and participating in the development of the free market of the U.S.S.R. and joint ventures. But we—and you should note—allow these credits to be redistributed through the state-owned budget.

And I think that the objections that my friend, Mr. Nove, had were the results of some kind of misunderstanding.

Representative SCHEUER. As I get it, you are saying that we should extend credits, but not across the board, not to state-owned institutions, but to the private sector, to the extent that we could do it.

Should we be thinking about regional accounting? Should we be thinking about self-accounting in the republics? Should we be making loans and investments to individual republics so that we can take clear aim and give the benefit of our aid with a high-powered rifle and an 8 power scope to the very sectors of a local economy in the republic where we can assume that it will not benefit the military capability of the Soviet Union where we can probably be more confident? Should we aim at enhancing republic self-sufficiency and republic accountability and working more within the republic than we do with the vast state organs in Moscow?

Mr. TIKHONOV. As a whole, I think that your ideas are very grounded and substantiated. I think there can be more places and object that the investments can go into, but the overall idea is grounded.

Representative SCHEUER. All right. Look, we have abused your patience and your tolerance. And we are very grateful to you.

FORECASTING THE SOVIET ECONOMIC CRISES

I am going to ask you all one question. This acceptance of the significant likelihood of a free fall in the Soviet economy that would affect industrial production, that perforce would affect consumer production, is a very new concept to me. I was flabbergasted to hear the directness, the specificity and the confidence which Ms. Shelton and both of you gentlemen used in expressing these views.

Were any of these phenomena predictable? Did other economists in the West tell us that the Soviet Union is on a collision course with economic reality and that they are going to be faced with what amounts to pressing the self-destruct button in the Soviet Union, an economic free fall that will have devastating effects throughout the length and breadth of Soviet society and will to a significant extent impinge on their industrial productivity and even on their defense capability? Who was talking about this? Who was warning us? Where in our CIA and where in other governments was any such prospect even considered seriously 6 months or 1 year ago?

Ms. Shelton, who were the Cassandras?

Ms. SHELTON. Well, I think the financial, the budgetary, the economic information was there, and in some ways I was surprised by numbers that I was seeing over the past few years when I was looking at this issue. The Soviets admitted a budget deficit for the first

time in late 1988. I do not think anyone was anticipating how immediate the connection would be between the approaching economic problem and the social turmoil and the spillover into the possibility of political upheaval.

I will say at the time that my book came out with this title of "The Coming Soviet Crash" it was considered sensationalist.

Representative SCHEUER. And when was you book published, Ms. Shelton?

Ms. SHELTON. February of last year.

Representative SCHEUER. So, you were a legitimate Cassandra. And I will explain to the audience that Cassandra was a Greek goddess who predicted the future and it was generally bad. She was an important figure in Greek mythology who always foresaw the gloom and doom coming ahead. You really played that role.

Ms. SHELTON. Well, frankly, I was relieved when the Soviets began confirming much of this information because like everyone else, even when the numbers indicate an inexorable conclusion, there is still a mindset that this is the Soviet Union we are talking about, and a country does not just fall apart over night. And yet, it was clear that the situation was untenable and would get worse and worse.

Now that the Soviets have confirmed much of what was being suspected on this side, it is frightening as well, but it is a relief that we did have some indications. We just did not maybe look at them seriously enough.

Mr. NOVE. I think that by the end of 1988 the alarm signals were beginning to ring in Moscow itself.

Representative SCHEUER. A little over a year ago.

Mr. NOVE. Yes. Well, by the end of 1988, the consumer market began to fall apart. Some of them even put a date to this, that something like October 1988 there was a breakdown of consumer confidence. God knows what you will be able to buy in the shops. Stock up. And the consumer market began its downward fall, and it has gone on falling downward.

Yes. It looked pretty gloomy. I was in the Soviet Union in January 1988 after a longish interval, and great alarm was being expressed by the more intelligent Soviet economists though all the time one felt, perhaps reflecting the point that Judy Shelton has just made, this is a great power, the leadership must now be told where they are heading. Something surely will be done.

But give a little credit to one Cassandra, one or two of the Soviet emigres in this country years ago—first of all, one of them was the first to say there was a hidden secret Soviet budget deficit. He wrote that about 7 years ago. Let's give him credit.

Representative SCHEUER. And who is this?

Mr. NOVE. The man is Igor Birman. He was at the conference. Some of the things he says make my hair curl, if I had more hair, but occasionally he absolutely hits the nail on the head. He 5, 6 years ago was saying the economy will proceed downward and they are on a real disaster course. I used to argue with him. "No, surely they will take some kind of measures." I could see the downward path. He stuck to his guns, and these particular guns—let's give credit where credit is due—proved to be there, and he was right.

Incidentally, at the Airlie House conference which he had quite a considerable part in helping to set up, the Soviet economists present, incuding Mr. Tikhonov, tended to support him rather than the CIA in any dispute between him and the CIA about any numbers. For what it is worth, it is also a point worth making.

Representative SCHEUER. Well, Mr. Tikhonov, do you have any final words?

Mr. TIKHONOV. With great interest, I am listening to the discussion, and I think that both Judy Shelton and Alec Nove are right.

Congressman Scheuer, I would like to emphasize again the last statement that Alec Nove said right now. It was back in 1983 that we in the Soviet Union were impressed by the high quality analytical publications of Igor Birman. In his polemics with the CIA, Igor Birman demonstrated the knowledge of the root factors of the Soviet economy. His book, "Economy of Deficiencies," that he published gave us momentum and described it better of the decreasing situation in our economy by that time.

Representative SCHEUER. Economy of——

Mr. NOVE. I think it is "Economics of Shortages." It has been published in English I think recently.

The Interpreter. "Economy of Shortages."

Mr. NOVE. Yes.

CONCLUSION

Mr. TIKHONOV. In conclusion, I would like to end with an optimistic tone. We are very rich in natural resources. Our country lacks management and wise management, but if we do manage to shift our system into the course of the market economy—and I think we will manage, although not very shortly—then the United States of America will have a very reliable and a very good partner, the Soviet Union.

Thank you very much for your time today.

Representative SCHEUER. Are there any other remarks by Mr. Nove or Ms. Shelton? [No response.]

Well, this has been a marvelously interesting hearing. Sorry that 535 Members of Congress were not sitting here listening to you and absorbing your words. We are all very grateful to you.

The hearing is adjourned.

[Whereupon, at 12:57 p.m., the committee adjourned, subject to the call of the Chair.]

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